

USPS-T-1

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

RATE AND SERVICE CHANGES TO IMPLEMENT
FUNCTIONALLY EQUIVALENT NEGOTIATED
SERVICE AGREEMENT WITH BRADFORD GROUP

Docket No. MC2007–4

DIRECT TESTIMONY OF

BRODERICK A. PARR

ON BEHALF OF THE

UNITED STATES POSTAL SERVICE

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AUTOBIOGRAPHICAL SKETCH

My name is Broderick A. Parr. I am currently an Economist in the Pricing Strategy Group of the United States Postal Service. I joined the Postal Service in May 2006. My primary responsibilities relate to analysis and pricing of, and compliance with, Negotiated Service Agreements (NSAs). I also contribute to the analysis of other pricing approaches, such as Repositionable Notes (RPNs).

Prior to joining the Postal Service, I was a Market Analyst with a nationwide metal buildings construction firm. I was responsible for developing marketing analytics to enhance company knowledge of current market conditions and competitive trends.

In 1988, I was employed as a Research Economist with an agribusiness consulting firm. My responsibilities involved the monitoring and analysis of United States and world crop conditions. I also forecasted crop yields and production in order to assess impact on commodity traders, food processors, and grain distributors worldwide.

I earned a Masters of Business Administration in Finance and a Bachelors of Business Administration in Economics in 1999 and 1988, respectively, from the University of Memphis.

I. PURPOSE AND SCOPE OF TESTIMONY

The purposes of my testimony are to present the specific terms and conditions of the functionally equivalent Negotiated Service Agreement (NSA) that the Postal Service has negotiated with Bradford Group, to describe the analytical support used to develop the NSA, to explain the financial implications of this NSA, to describe the provisions that are intended to minimize the risk associated with forecasting volumes for a single mailer, and to explain the steps the Postal Service has taken to understand the market in which Bradford Group operates. Finally, my testimony shows how the changes proposed to implement the NSA conform to the pricing and classification criteria of the Postal Reorganization Act.

In addition to my testimony, the Postal Service relies on the Direct Testimony on behalf of Bradford Group of Steve Gustafson (BG-T-1) and Wendy Ring (BG-T-2). I have reviewed Mr. Gustafson's and Ms. Ring's testimonies, and affirm that they may be relied upon in presentation of the Postal Service's direct case.

II. TERMS AND CONDITIONS OF THE BRADFORD GROUP NSA

A. Solicitation Incentives and the Multiplier Effect

The Bradford Group NSA is relatively simple. It is designed to provide incentives to Bradford Group to increase its use of Standard Mail letters and flats for the purpose of selling collectibles to a nationwide customer base. Direct mail expense is an important cost component for The Bradford Group. Without an incentive such as that provided by the proposed NSA, Bradford Group marketing volumes are expected to be flat or falling due to the highly volume variable nature of Bradford Group's operations.

1 The incentives are based on volumes of, and apply to, Bradford Group's Standard Mail
2 solicitation letters and flats.

3 Solicitations are defined as letters and flats sent as Standard Mail by Bradford
4 Group seeking customers for collectibles and gift items. The incentives will encourage
5 Bradford Group to mail additional solicitation letters and flats, increasing its customer
6 base. The Postal Service benefits from the additional contribution generated by an
7 increased volume of Standard Mail solicitations. The total estimated net benefit to
8 postal finances over the three-year period of this NSA is \$5.4 million, as shown in
9 Appendix A and explained in Appendix B. The Postal Service will also benefit from the
10 additional revenue generated by increased volume for each new customer in the form of
11 First-Class Mail and Standard Mail correspondence, fulfillment, and additional
12 solicitations, known as their multiplier effect.

13 **B. Declining Block Rates with Volume Commitments**

14 The incentives in this NSA take the form of two declining block rate structures,
15 one for Standard Mail letter volumes and another for Standard Mail flat volumes at
16 negotiated levels. In addition, because this NSA provides discounts for both letters and
17 flats, it will mitigate the potential for letter-flat conversion. Regardless, the Postal
18 Service does not expect any significant conversion between letters and flats, based on
19 an analysis of Bradford Group's volume histories and forecasts. This NSA uses the
20 same volume commitment mechanism as the Bookspan NSA, designed to mitigate risk
21 that could result from the underestimation of before-rates volume. According to the
22 agreement, before the discounts earned at a negotiated volume level are payable,
23 Bradford Group must first meet a higher volume commitment. For instance, in the first

1 year of the agreement, 146,500,000 letter pieces and 53,500,000 flat pieces are
2 projected before rates. Discounts would be earned for volumes above the thresholds of
3 147 million and 53.5 million pieces for letters and flats, respectively. However, the
4 discounts would not be paid unless Bradford Group actually mails 154,000,000 letters
5 (to receive the letter discounts) and/or 54,500,000 flats (to receive the flats discounts).

TABLE 1: DECLINING BLOCK RATE STRUCTURE – STANDARD MAIL LETTERS & FLATS

Year 1 Structure					
LETTERS			FLATS		
Before-Rates Volume Forecast:					
146,500,000			53,500,000		
LETTER Volume Blocks		Incremental Discount	FLATS Volume Blocks		Incremental Discount
147,000,000	157,000,000	1.5 cents	53,500,000	55,500,000	1.0 cents
157,000,001	167,000,000	2.0 cents	55,500,001	57,500,000	1.2 cents
167,000,001	177,000,000	2.5 cents	57,500,001	59,500,000	1.5 cents
177,000,001	183,000,000	3.0 cents	59,500,001	61,500,000	2.0 cents
Volume Commitment: 154,000,000			54,500,000		

TABLE 1: DECLINING BLOCK RATE STRUCTURE – STANDARD MAIL LETTERS & FLATS (CONT.)

Year 2 Structure

LETTERS			FLATS		
Before-Rates Volume Forecast: 147,600,000			54,400,000		
LETTER Volume Blocks		Incremental Discount	FLATS Volume Blocks		Incremental Discount
147,000,000	157,000,000	1.5 cents	54,500,000	56,500,000	1.0 cents
157,000,001	167,000,000	2.0 cents	56,500,001	58,500,000	1.2 cents
167,000,001	177,000,000	2.5 cents	58,500,001	60,500,000	1.5 cents
177,000,001	183,000,000	3.0 cents	60,500,001	62,500,000	2.0 cents
Volume Commitment: 154,000,000			55,500,000		

Year 3 Structure

LETTERS			FLATS		
Before-Rates Volume Forecast: 147,000,000			57,000,000		
LETTER Volume Blocks		Incremental Discount	FLATS Volume Blocks		Incremental Discount
147,000,000	157,000,000	1.5 cents	57,000,000	59,000,000	1.0 cents
157,000,001	167,000,000	2.0 cents	59,000,001	61,000,000	1.2 cents
167,000,001	177,000,000	2.5 cents	61,000,001	63,000,000	1.5 cents
177,000,001	183,000,000	3.0 cents	63,000,001	65,000,000	2.0 cents
Volume Commitment: 154,000,000			58,000,000		

C. Annual Adjustment Mechanism for Volume Commitments- Standard Mail Letters

The volume commitment is subject to adjustment each year, based on actual volumes mailed in the previous year. The adjustment mechanism mitigates both the risks associated with forecasting errors and the effects that future rate increases will have on volumes. The agreement provides that, if at the end of the agreement year (12 consecutive months), actual volumes are 12 percent or more above that year's commitment, the next year's volume commitment will be recalculated as the arithmetic mean of the current year's actual volume and the original volume commitment for the next year. For example, if at the end of Year 1, the actual volume of Standard Mail letters reached 175,000,000 pieces, the Year 2 volume commitment would increase from 154,000,000 to 164,500,000 letters.¹ Thus, Bradford Group would have to mail 164,500,000 letters in Year 2 in order to receive the discounts provided for volumes above 147,000,000 letters. If at the end of each year, actual volume is five percent or more below that year's volume commitment, then the next year's volume commitment will be decreased by the percentage difference between the actual volume and that year's volume commitment. For example, if at the end of Year 2, the volume of Standard Mail letters were 140,000,000, the Year 3 volume commitment would be reduced from 154,000,000 to 140,000,000 letters.² In the event that the volume commitment falls below the starting threshold in any year, the starting threshold will then equal the adjusted volume commitment. Furthermore, the new volume commitment will then become the beginning threshold plus seven million letter pieces.

¹ $(175,000,000 + 154,000,000) \div 2 = 164,500,000$

² $154,000,000 - (154,000,000 \times ((154,000,000 - 140,000,000) \div 154,000,000)) = 140,000,000$

D. Annual Adjustment Mechanism for Volume Commitments - Standard Mail Flats

The volume commitment is subject to adjustment each year, based on actual volumes mailed in the previous year. The adjustment mechanism mitigates both the risks associated with forecasting errors and the effects that future rate increases will have on volumes. The agreement provides that, if at the end of the agreement year (12 consecutive months), actual volumes are 12 percent or more above that year's commitment, the next year's volume commitment will be recalculated as the arithmetic mean of the current year's actual volume and the original volume commitment for the next year. For example, if at the end of Year 1, the actual volume of Standard Mail flats reached 65,000,000 pieces, the Year 2 volume commitment would increase from 55,500,000 to 60,250,000 flats.³ Thus, Bradford Group would have to mail 60,250,000 flats in Year 2 in order to receive the discounts provided for volumes above 54,500,000 flats. If at the end of each year, actual volume is five percent or more below that year's volume commitment, then the next year's volume commitment volume will be decreased by the percentage difference between the actual volume and that year's commitment volume. For example, if at the end of Year 2, the volume of Standard Mail flats were 49,000,000, the Year 3 volume commitment would be reduced from 58,000,000 to 51,207,207 flats.⁴ In the event that the volume commitment falls below the starting threshold in any year, the starting threshold will then equal the adjusted volume commitment. Furthermore, the new volume commitment will then become the beginning threshold plus one million flat pieces.

³ $(65,000,000 + 55,500,000) \div 2 = 60,250,000$

⁴ $58,000,000 - (58,000,000 \times ((55,500,000 - 49,000,000) \div 55,500,000)) = 51,207,207$

E. Termination Clauses

This NSA incorporates two unencumbered termination clauses that provide substantial additional protection to both parties. The first provides both parties with an unconditional right to terminate the agreement, without penalty, with 30 days' written notice to the other party. The second provides that the agreement automatically terminates and all discounts cease if Bradford Group's Standard Mail letter volume exceeds 195,000,000 in any year, or flats volume exceeds 73,500,000 in Year 1, 74,500,000 in Year 2, or 77,000,000 in Year 3.

III. FINANCIAL IMPACT

Three aspects of this NSA affect the Postal Service's finances. The first is the net contribution from additional volumes of Standard Mail letters and flats in response to the rate incentive. Based on Bradford Group's projected volume forecast for new letters and flats, the estimated new contribution for the three-year agreement is approximately \$6.6 million. The second financial impact is the expected discount exposure on both letters and flats. The discount exposure is the result of price incentives applied to any volume that would have been generated without a price incentive. The declining block rates were designed to apply only to volumes that are above before-rates forecasted volume; after rounding the thresholds to the nearest million pieces, total discount exposure on both letters and flats is only \$9,000 over the three-year agreement.

The final financial impact is the amount of the total incremental discounts, projected to be \$1.2 million. Thus the total estimated financial impact over the three-year period of this NSA is a net benefit to the Postal Service of \$5.4 million. The Postal

1 Service proposes to collect data necessary to determine the actual financial impact of
2 the NSA. The data collection plan is described in Appendix E.

3 A second stream of value for the Postal Service is generated as a result of the
4 “multiplier effect.” Bradford Group’s multiplier effect is described more fully in the
5 testimony of Steve Gustafson (BG-T-1). The Postal Service did not include the financial
6 benefits from the multiplier effect in evaluating the financial value of this NSA.

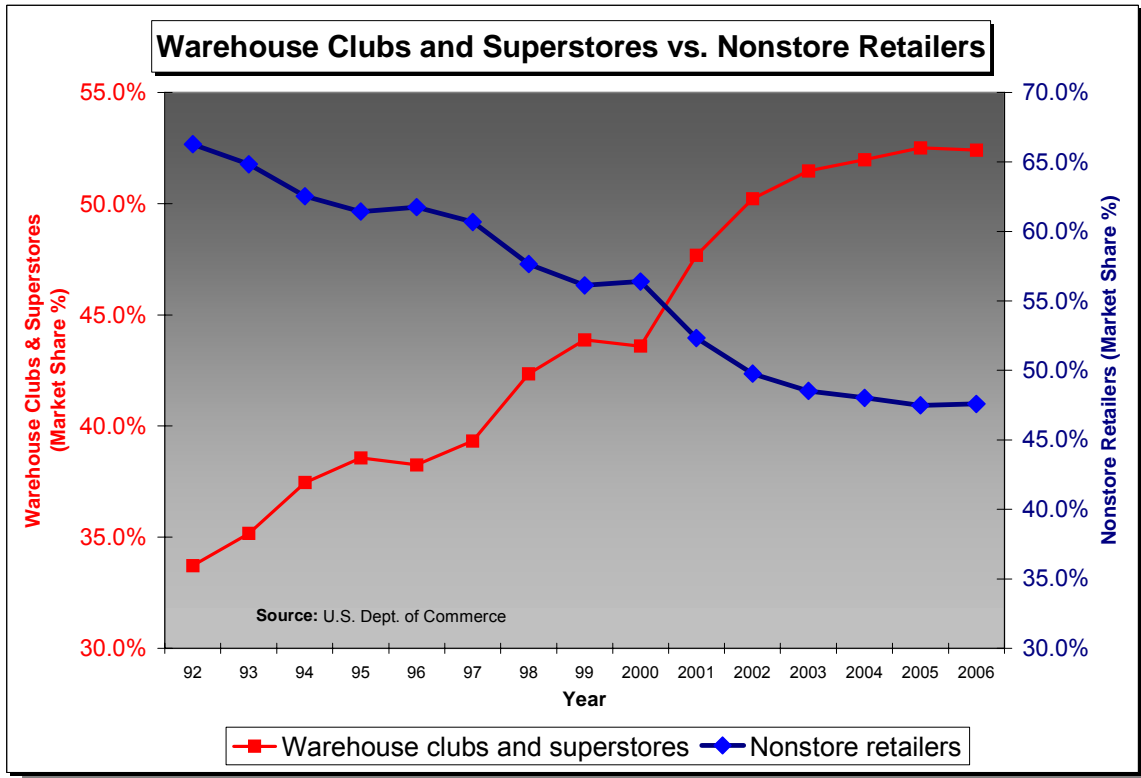
7 **IV. EVALUATION OF VOLUME FORECASTS**

8 **A. Before-Rates Volume Forecasts**

9 To evaluate Bradford Group’s before-rates volume forecasts and the potential
10 growth in its use of mail as a marketing medium, I utilized a variety of tools. My analysis
11 is comparable to that performed in evaluating previous NSAs and includes company-
12 specific research, volume trend analysis, and analysis of the market environment.
13 Based on this analysis, which is described below, the before-rates volume forecasts
14 provided by Bradford Group are reasonable.

15 The North American Industrial Code System classifies Bradford Group under
16 NAICS: 454, Nonstore Retailers because of its type of business. Figure 1 below
17 illustrates how Warehouse Clubs and Superstore retailers (NAICS: 45291) like Super
18 Wal-Mart, Sam’s Warehouse and other “big box” retailers have become major
19 competitors to catalogers and other nonstore retailers.

1 **Figure 1**



2
3 It is evident that nonstore retailers such as Bradford Group have been
4 experiencing eroding market share from 2001 to 2005 while Warehouse Clubs and
5 Superstore retailers have been strengthening share over the same time frame. Thus, I
6 believe The Bradford Group before-rates volume forecasts are consistent with the
7 dynamics of the market within which Bradford Group participates.

8 **1. Company-specific research**

9 Data on Bradford Group is limited because it is a privately held company and
10 therefore is not subject to the same reporting requirements as firms whose shares are
11 traded publicly. Based on research into the collectibles industry, past financial
12 transactions and discussions with Bradford Group, the Postal Service is able to make
13 informed inferences regarding Bradford Group's marketing strategies and its potential
14 for growth over the next several years. Bradford Group relies on mail as an important

1 marketing channel. Our research suggests that the profitability and future growth
2 prospects for Bradford Group may be limited due to market trends discussed below. My
3 research also suggests that, between 2003 and 2006, the number of buyers of Bradford
4 Group's products has decreased by around 20 percent in its core collectibles business.
5 It is unlikely that Bradford Group's mail volume could increase significantly in the current
6 business and market environment in the absence of this proposed agreement. This
7 adds credence to the before-rates volume forecast provided by Bradford Group, which
8 is consistent with its recent volume trend.

9 **2. Volume trend analysis**

10 Bradford Group provided the Postal Service with counts of its Standard Mail letter
11 and flat volumes for calendar years 2004 through 2006. These volumes have been
12 reconciled with Postal Service permit data. The data show that Bradford Group's
13 Standard Mail letter volume through 2005 trended substantially upward, but declined in
14 2006. This downward pressure is expected to continue on Bradford Group's Standard
15 Mail volume.

16 Because mail is Bradford Group's primary means of acquiring customers, this
17 volume decline would result in diminished customer account growth for Bradford Group
18 and further reduction in the volumes of various types of mail for the Postal Service. This
19 decline is expected to level off at the new lower level in the absence of an incentive to
20 increase solicitation of customers.

21 **3. Analysis of the market environment**

22 The collectibles market is highly fragmented across a wide variety of products.
23 Competitors of Bradford Group include brick-and-mortar retail gift-shops, mail-order gift

1 sellers, and internet gift sellers. Some competitors are in more than one category.

2 Bradford Group is unique in its reliance on the mail for almost all aspects of its
3 business.

4 Shoppers have been turning away from popular 'giftables' categories, such as
5 flowers and plants, figurines, collectibles, stationery, seasonal decorations, and other
6 popular gift items sold in specialty gift stores. The market for collectibles and gift
7 figurine sales in the United States has been steadily decreasing over at least the past
8 six years. The industry appears to be maturing as many competitors of Bradford Group
9 diversify their revenue streams to sustain growth by offering gifts of consumables, such
10 as chocolates and gourmet food. Others market entertainment and recreational
11 choices, such as videos/DVDs, CDs, and electronics. This indicates that extensive
12 growth is not expected by firms that are solely in the business of marketing and
13 distributing collectible gift items, such as Bradford Group.

14 In addition, traditional gift-item retailers, such as Bradford Group, are being
15 challenged by the emergence of the Internet as a channel for sales, both retail sales as
16 well as peer-to-peer and auction sales through sites such as eBay. The growth of the
17 Internet channel seems to have made it more difficult for Bradford Group and other
18 retailers like them to attract younger consumers (the average age of a Bradford Group
19 catalog purchaser is 45 years). As more consumers turn away from brick-and-mortar
20 stores and catalogs, it will be more difficult for traditional collectible retailers to retain
21 and expand their markets without diversifying away from mail advertising.

22 With limited growth potential for the total U.S. collectibles market, retailers are
23 increasingly competing for market share, rather than relying on increasing market size

1 as the primary opportunity for sales increases. Moreover, it appears that general
2 merchandisers and online retailers may continue to increase market share at the
3 expense of gift and collectible manufacturers and specialty gift retailers.

4 **B. After-Rates Volume Forecasts**

5 Although Bradford Group itself is in the best position to provide after-rates
6 volume forecasts, the Postal Service believes that Bradford Group's presentations of its
7 future plans are reasonable and can be relied upon to support the agreement. They are
8 also consistent with the Postal Service's independent analysis, as discussed previously
9 with respect to the before-rates forecast. *Ceteris paribus*, the incentives will encourage
10 Bradford Group to increase its use of mail. This should enable Bradford Group to
11 compete more effectively, since it will be able to increase its marginal marketing
12 spending in order to add to its customer base. The risks associated with overestimating
13 the after-rates volume is a topic that is addressed in more detail below. And as
14 described above, risk mitigating features are incorporated into this agreement. To the
15 extent that the after-rates volume forecasts underestimate Bradford Group's volume
16 response to the price incentives, the benefits to the Postal Service will exceed those
17 presented in this case.

18 **C. Risk Mitigation**

19 The Bradford Group NSA, when considered in purely economic terms, provides
20 the Postal Service with an increase in net contribution with very limited risk. As
21 described above, there are four contractual terms that limit the residual risk in the out-
22 years of the agreement. These features provide additional protection from various risks.

1 The first feature, which reduces risk from deviation in volume forecasts, is an
2 adjustment mechanism that uses actual volumes from the previous year to establish
3 projected commitment volume thresholds for the following year. The second feature,
4 which provides additional protection from deviation in forecasting before-rates volumes
5 and also reduces the risk of discount leakage, requires that actual volumes exceed
6 incentive volume thresholds before discounts are payable. The third feature, which
7 provides protection for the Postal Service against overestimation of after-rates volumes,
8 is the automatic termination provision of the agreement, which is further described in
9 Section II.E above. The fourth feature is a provision that unconditionally allows either
10 party to terminate the agreement with 30 days' written notice to the other party. This
11 reduces risks to the Postal Service that could result from a change in Bradford Group's
12 business model or use of the mails, reduces the risk of discount exposure, and protects
13 both parties against a broad range of unforeseen risks.

14 **D. Sensitivity Analysis**

15 By definition, forecasts are estimates, and the actual volume will almost certainly
16 deviate from the point estimates used in my analysis. Such deviation from forecasts
17 would cause changes in the valuation of this NSA agreement. As stated previously, and
18 as shown in Appendix A, based on the volume projections presented by Bradford
19 Group, the three-year NSA has a value to the Postal Service of \$5.4 million. To
20 evaluate deviations from this projection, a sensitivity analysis was used to identify the
21 possible value of the NSA, assuming varying percentage changes in the before-rates
22 volumes forecast and varying percentage changes in the after-rates volume forecasts.
23 The tables presented in Appendix C are sensitivity matrices that show the potential

range of values of this NSA under alternative sets of assumptions. The table illustrates that a net loss could occur only under extreme mis-estimation assumptions.

V. OTHER IMPACTS

The Commission's rules require an examination of the effects of the NSA on the competitors of the NSA partner, competitors of the Postal Service, and mail users. A summary of the examination I conducted follows.

A. Competitors of Bradford Group

As noted above, while negotiating this NSA, the Postal Service analyzed the gift, novelty, and souvenir stores market within which Bradford Group operates. According to my analysis of internal Postal Service customer data, Bradford Group is unique among its competitors in its use of the mail as an important means of marketing. Although its competitors may make some use of the mail for marketing purposes, their reliance on mail is not comparable to that of Bradford Group. Bradford Group could earn over \$1 million in price incentives over the three years of the agreement.

Bradford Group's competitors who rely more on other forms of advertising already have the ability to negotiate price terms with their suppliers. Thus, the NSA may serve to rectify a competitive disadvantage that currently exists for Bradford Group in the context of fixed postal rates. Moreover, any competitor of Bradford Group that intends to use and increase its share of mail as a marketing medium may negotiate a comparable agreement to this NSA. Thus, the NSA's effect on Bradford Group's competitors is not expected to be significant and the NSA may bring the benefits of increased competition to the marketplace.

B. Competitors of the Postal Service

Competitors of the Postal Service are not affected by this agreement. Bradford Group relies on the mail as a marketing channel because of its use of mail as a fulfillment medium which makes mail a more natural acquisition medium. The response rates and secondary effects of mail and other marketing mediums differ, and they are therefore imperfect substitutes for Bradford Group.

The incentives in this agreement are intended to allow Bradford Group to use the mail to market to more potential customers than it would otherwise have found profitable. Given the business model that is described by the Bradford Group witnesses, this will inevitably result in growth in letter and flat volumes mailed by Bradford Group. Because Bradford Group has used the Postal Service for most of its fulfillment needs and intends to continue to do so, the expected increase in package volumes shipped by Bradford Group will not come at the expense of competitors. Nothing in the agreement requires Bradford Group to continue to utilize the Postal Service for its distribution of packages.

C. Mail Users

Mail users will experience minimal impact from this NSA. Although the estimated total USPS value of the three year proposal is \$5.4 million is positive, it is small enough that there will be little measurable value to any other specific mailers.

**VI. THE PROPOSALS ARE CONSISTENT WITH THE RATE AND
CLASSIFICATION CRITERIA OF THE ACT**

Title 39, Section 3623 requires that the Commission evaluate proposed changes in the classification schedule in accordance with the policies of the Title and the following factors:

1. The establishment and maintenance of a fair and equitable classification system for all mail;
2. The relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and services of mail;
3. The importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;
4. The desirability of special classifications from the point of view of both the user and of the Postal Service; and
5. Such other factors as the Commission may deem appropriate.

Section 3622(b) requires that postal rates and fees reflect the policies of the Postal Reorganization Act, and accord with the following factors:

1. The establishment and maintenance of a fair and equitable schedule;
2. The value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to, the collection, mode of transportation, and priority of delivery;
3. The requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type;
4. The effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters;
5. The available alternative means of sending and receiving letters and other mail matter at reasonable costs;
6. The degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service;
7. Simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services;
8. The educational, cultural, scientific, and informational value to the recipient of mail matter; and
9. Such other factors as the Commission deems appropriate.

1 The proposed agreement between Bradford Group and the Postal Service
2 satisfies these criteria. First, the Postal Service believes that by negotiating directly with
3 individual customers, it may be possible to more accurately present prices that
4 represent the value that the user places on the service being provided (pricing criterion
5 2) for mail classifications that are desirable to the mailer and the Postal Service
6 (classification criterion 5). The customer-specific rates offered to Bradford Group more
7 than cover the costs associated with Bradford Group's mail (pricing criterion 3) and
8 directly address the requirement of covering all costs. The classifications and prices
9 presented in this agreement confer beneficial effects on the general public and other
10 business mail users (pricing criterion 4). The public will benefit from receiving additional
11 information regarding collectibles offered by Bradford Group and the purchase options
12 for those collectibles. The business user obviously benefits with the enhanced ability to
13 market to additional customers. The proposed declining block rate structure is relatively
14 simple and maintains a transparent, identifiable relationship between volume levels and
15 applicable rates and fees (pricing criterion 7). While the proposal does not specifically
16 create new workshare categories, it provides the incentives for low-cost Standard Mail
17 letters and flats consistent with criterion 6.

18 The proposed agreement between the Postal Service and Bradford Group also
19 meets the relevant classification criteria. The proposal provides a special classification
20 that meets the needs of the customer and reflects the relative value of the additional
21 pieces. In addition, the classification is desirable from the point of view of the customer
22 and the Postal Service.

1 Finally, the proposed rates and classifications under this NSA are fair and
2 equitable. The proposal reflects a balanced consideration of the applicable criteria. I
3 believe the directly affected customers are served by the proposal and no customer is
4 harmed. In addition, as discussed earlier in my testimony, the pricing structure
5 promoting additional usage of the mail is not that different from structures employed by
6 other media that promote additional usage. As such, the Postal Service does not
7 unfairly compete.

8 **SUMMARY AND CONCLUSION**

9 For the reasons given above, the Commission should recommend the changes in
10 rates and classifications proposed by the Postal Service to allow it to effectuate its
11 agreement with Bradford Group. As explained above, I estimate that the NSA will
12 produce incremental contribution gains of \$6.6 million. Additionally, the Postal Service
13 benefits not only from the additional contribution generated by an increased volume of
14 Standard Mail solicitation letters and flats, but also from a stream of additional volume
15 and contribution generated for each new collectibles customer, in the form of fulfillment,
16 and First-Class Mail correspondence described as the “multiplier effect.”

Appendix B

Explanation of Financial Model

The Bradford Group Model incorporates all of the relevant cost and revenue-per-piece data into one comprehensive workbook. It serves as a presentation mechanism for the customer-specific revenue and cost calculations. The historical and forecasted volumes are provided by the Bradford Group witness. These inputs provide the basis for calculating the value of the NSA.

Assumptions

The assumptions page contains two factors impacting the three-year duration of the agreement. The first assumption, the inflation cost adjustment factor, represents the inflationary cost growth projected by the Postal Service. Currently, the inflation factor is 2.06 percent and 1.94 percent respectively in the second and third years. (Global Insight April 2007 baseline 10-year macroeconomic forecast of CPI-U). Year 1 costs use Docket No. R2006-1 Test Year data, and need not be inflated. This inflation factor is also applied to the average unit revenue as an estimate of price changes over the life of the agreement. The second assumption, the contingency factor, is the multiplicative factor applied uniformly to all forecast Postal costs. Currently, the contingency provision is 1.01. (Docket No. R2006-1, USPS-T-6, page 62)

Volume Calculations

The volume calculations contain Bradford Group historical mail volumes for FY 2004-2006 for Standard Mail letters and flats for solicitation and fulfillment. These volumes have been identified through the USPS permit system and through the

reconciliation process conducted with Bradford Group. To illustrate the letter and flat volume response to rate incentives, the Bradford Group witness has provided the volume forecasts for Bradford Group, both in the absence of an agreement (Before Rates) and in the presence of an agreement (After Rates).

Standard Mail Revenue Calculations

The rate categories presented in the model represent the specific Standard Mail letter and flat mail profile of Bradford Group. The Bradford Group revenue-per-piece calculation is based on the total revenue per rate category divided by the total volume per rate category. This provides a representation of the estimated revenue per piece for Bradford Group solicitation letters and flats volumes. This calculation is based on a prior twelve-month period of Standard Mail Regular Billing Determinants. The revenue calculations use prices which took effect May 14, 2007, and the volume data have been adjusted to conform to rate-category changes associated with the price change.

Standard Mail Cost Calculations

The rate categories presented in the cost calculation represent the Standard Mail profile of Bradford Group. The unit costs per rate category for Standard Mail letters and flats are based on the PRC workpapers Docket No. R2006-1, Test Year FY2008. A prior twelve-month period of Standard Mail letter and flat volumes are used since these are the latest full year historical volumes available. The total unit cost estimate for Bradford Group has been derived by multiplying the weighted distribution of Bradford Group prior twelve-month period of historical volumes by the Test Year FY2008 unit costs per rate category.

Discount and Exposure

For all years of the NSA, the declining block rate structure for letters begins with a discount of 1.5 cents per piece for the block beginning at 147,000,000 pieces, and ends at 157,000,000 pieces. The second discount tier of 2.0 cents per piece begins at 157,000,001 pieces, and ends at 167,000,000. The discount is effective once the volume level has reached 154,000,000 pieces. The exposure to the USPS measures the discounted revenue associated with declining block rates for mail volume that Bradford Group would have mailed in the absence of the proposed NSA (before-rates forecast volumes). Only the second year has before rates forecast letter volumes above the initial starting discount level. (Appendix A, page 2) Therefore, there is only exposure for the letter volumes that Bradford Group will mail with the NSA in the second year of the agreement (referenced as after rates forecast volumes, Appendix A, page 2) The model calculates exposure by multiplying the difference between the volume tier and before-rates forecast volume by the corresponding discount. All letter discounts earned during the three year period of the agreement total \$1,066,000.

In the first year of the NSA, the declining block rate structure for flats begins with a discount of 1.0 cent per piece for the block beginning at 53,500,000 and ends at 55,500,000 pieces. The second discount tier of 1.2 cents per piece begins at 55,500,001 and ends at 57,500,000. The discount is effective once the volume level has reached 54,500,000. The exposure to the USPS measures the discounted revenue associated with declining block rates for mail volume that Bradford Group would have mailed in the absence of the proposed NSA (before-rates forecast volumes). The first year has before rates forecast letter volumes above the initial starting discount level.

(Appendix A, page 2) Therefore, there is exposure for the flats volumes that Bradford Group will mail with the NSA in the first year of the agreement (after-rates forecast volumes, Appendix A, page 2).

In the second year of the NSA, the declining block rate structure for flats begins with a discount of 1.0 cent per piece for the block beginning at 54,500,000 and ends at 56,500,000 pieces. The second discount tier of 1.2 cents per piece begins at 56,500,001 and ends at 58,500,000. The discount is effective once the volume level has reached 55,500,000. The second year has before-rates forecast volumes below the initial starting discount level. (Appendix A, page 2) Therefore, there is no exposure for the flats volumes that Bradford Group will mail with the NSA in the second year of the agreement (after-rates forecast volumes, Appendix A, page 2).

In the third year of the NSA, the declining block rate structure begins with a discount of 1.0 cent per piece for the block beginning at 57,000,000 and ending at 59,000,000 pieces. This discount is effective once the volume level has reached 58,000,000 pieces. The block for the second discount of 1.2 cents per piece begins at 59,000,001 pieces and ends at 61,000,000 pieces. The before-rates volume equals the initial starting discount level, therefore there is no flats exposure for FY2010. All flats discounts earned during the three year period of the agreement total \$121,500.

Contribution Inputs

The contribution inputs calculate the contribution per piece of Bradford Group's Standard Mail solicitation letter and flat volume. The per-piece calculation provides the Postal Service with before- and after-rates revenue, cost, and contribution for Standard Mail on a customer-specific basis. It allows for forecasting future contribution per piece

in the out-years of the agreement by allowing the inflationary growth (referenced Appendix A, page 1, (1)) to be multiplied by the cost of each mail shape.

USPS Value

The total USPS value is calculated by taking the total new contribution less the total exposure and discount. The total new contribution value is calculated from new contribution of new solicitation letter and flat volume above the before rates forecast volumes multiplied by the contribution value per piece.

Appendix C
Value To Volume Sensitivity Matrix
Based on Year 1

Table 1:

			After Rates Letter Volume							
Volumes (millions)			154.0	161.3	164.6	168.0	176.4	184.8	195.0	
% Change			(8.3%)	(4.0%)	(2.0%)	0.0%	5.0%	10.0%	17.3%	
Before Rates Letter Volume	102.6	(30.0%)	\$ 4.8	\$ 5.3	\$ 5.6	\$ 5.8	\$ 6.3	\$ 6.8	\$ 7.4	
	117.2	(20.0%)	\$ 3.5	\$ 4.0	\$ 4.3	\$ 4.5	\$ 5.0	\$ 5.5	\$ 6.1	
	131.9	(10.0%)	\$ 2.2	\$ 2.7	\$ 3.0	\$ 3.2	\$ 3.7	\$ 4.2	\$ 4.8	
	146.5	0.0%	\$ 0.9	\$ 1.5	\$ 1.7	\$ 1.9	\$ 2.4	\$ 2.9	\$ 3.5	
	161.2	10.0%	\$ (0.3)	\$ 0.2	\$ 0.4	\$ 0.6	\$ 1.2	\$ 1.6	\$ 2.2	
	175.8	20.0%	\$ (1.6)	\$ (1.1)	\$ (0.9)	\$ (0.7)	\$ (0.1)	\$ 0.4	\$ 0.9	
	190.5	30.0%	\$ (2.9)	\$ (2.4)	\$ (2.2)	\$ (2.0)	\$ (1.4)	\$ (0.9)	\$ (0.3)	

The row stubs show the assumed variance between the before-rates letter volume forecast and the “actual” before-rates letter volume. The column headings show the assumed variance between the after-rates letter volume forecast and the “actual” after-rates letter volume. The interior cells are expected USPS values in millions of dollars as a result of the before- and after-rates letter volume combinations. For instance, at 0 percent change for both before-rates and after-rates letter volumes, the expected USPS value is \$1.9 million, the expected USPS value in Year 1 of the agreement. Other before- and after-rates letter volumes and their corresponding USPS values are as a result of the percentage change from the Year 1 expected before- and after-rates letter volumes. Flats are held constant throughout the scenario at the before- and after- rates flats volume of Year 1 of the agreement.

The relationship between before- and after-rates volumes provides a type of implicit protection for the Postal Service. Assuming that price incentives will encourage volume response under all circumstances, it is highly unlikely that the before-rates volume could be underestimated at the same time the after-rates volumes are overestimated. Exogenous changes that affect the before-rates volume will have a very similar impact on after-rates volume, since it is highly unlikely that a variable could cause the before-rates volumes to rise and after-rates volume to decrease. Simply because it is a forecast, the actual before-rates letter volume for Year 1 is uncertain. For illustrative purposes, the table presents a range of before- and after-rates volumes beyond those that Bradford Group and the Postal Service believe are reasonable estimates.

Appendix D
MC2004-3 Opinion and Further Recommended Decision Analysis
Panzar Formula

As explained by the Commission in Docket No. MC2004-3, the “Panzar” test seeks to assure a net increase in contribution to the Postal Service for every possible after-rates volume within the range of a proposed NSA, thereby contributing positive value to the Postal Service while protecting non-participating mailers. The Bradford Group NSA satisfies parameters of the analysis, assuming Bradford Group’s own-price elasticity of demand for Standard Mail letters and flats is equal to the subclass average as calculated in the models used by witness Thress in Docket No. R2006-1 (USPS-T-7).

Appendix E

Proposed Data Collection Plan

The USPS plans to collect the following data pertaining to the NSA with Bradford Group and include the following items in its Data Collection Plan:

1. The volume of solicitation Standard Mail letter-shape and flat-shape pieces by rate category in eligible Bradford Group accounts;
2. The discounts paid to Bradford Group for letter-shape and flat-shape solicitation Standard Mail by incremental volume block;
3. Monthly estimates of the amount of time spent on compliance and a description of the activities performed.
4. A comparison of the estimated mailer-specific costs and revenues with the actual mailer-specific costs and revenues.
5. An evaluation of the impact of the Agreement on contribution.
6. An evaluation of the effectiveness of the Agreement using the Panzar analysis.
7. A narrative comparison of Bradford Group's actual volumes by rate category with:
 - a. Before-rates forecast
 - b. After-rates forecast
 - c. Subclass totals
 - d. Relevant benchmarks based on research using available and/or commissioned sources where possible. This will include an analysis of any significant exogenous impacts.

8. The volume of solicitation Standard Mail letter-size mailpieces that included strategic business alliance inserts on a quarterly basis. This information shall be provided by rate category and by whether the mailpieces included one or two inserts.